



PERISCOPE

Public Employee Retirement Systems

The IRS Pays a Call on Public Retirement Plans

by Craig Glyde

Earlier this year, the Internal Revenue Service (IRS) indicated its intent to establish a “meaningful presence” in the governmental retirement plan arena, and opened the dialogue with government plans at a roundtable meeting on April 22, 2008. In addition to encouraging government plans and retirement systems to file by January 31, 2009 for a “determination letter”, that certifies that their plan is in compliance with the Internal Revenue Code (IRC), the IRS gave notice that it will increase its oversight and examination of government plans. However, by its own admission, the IRS has relatively little experience in examining these plans.

To better understand the difficulties these plans face complying with federal tax requirements, the IRS is going to survey a select group, fewer than 40 government plans. A more comprehensive survey is scheduled to go out later this fall to approximately 200 plans, based on results obtained in the pilot survey. A public report is to be issued by year end. Survey respondents are being assured that any noncompliance issues identified will not result in an IRS examination; instead, respondents will be given directions on how to correct any issues that exist.

Ironically, one of the main roadblocks facing a government plan is how exactly to apply for a determination letter. The current filing process assumes the existence of a formal plan document, as is the case for private plans. Because many government retirement programs are set up by statutes or ordinances and do not have a formal plan document, the IRS is working to provide some needed guidance. In an effort to provide this guidance and answer other questions, the IRS has added a Governmental Plans section to its Web site (www.irs.gov) and encourages government plans to submit questions, comments, and suggestions.

Why get a determination letter?

A retirement plan does not need a determination letter to be qualified. To be qualified, a plan must have a written document that details the benefits it will provide and how the plan will operate in compliance with applicable IRC requirements. Then the plan must subsequently operate in accordance with the terms of the document

and IRC rules and regulations. If either of these requirements is not met, the plan may be disqualified, possibly leaving members subject to immediate taxation. In addition, disqualification may lead to the plan losing certain governmental plan exceptions included in the IRC, such as the special tax treatment exception regarding pick-up contributions (IRC section 414(h)(2)). (See the sidebar for more on what it means to be “qualified.”)

A favorable determination letter says that the plan detailed in the written document meets IRC qualification requirements. Provided a system operates consistently with the governing document, it may rely on the determination letter as evidence of its tax-qualified status. The comfort of knowing the plan has reduced its risk of disqualification may be incentive enough to apply for a determination letter. Having a determination letter also provides access to other IRS programs and services that may otherwise be unavailable, including certain aspects of the Employee Plans Compliance Resolution System (EPCRS)¹.

Should my plan apply for a determination letter?

This is a decision each plan has to make based on its own situation. For some, the answer may be clear; for others it may require careful consideration. The plan should seek appropriate legal and tax counsel before deciding what course of action to take.

Fiduciaries of private retirement plans have it a bit easier. The determination letter process is clearly defined for them. Filing requirements typically include the latest determination letter received from the IRS and copies of all subsequent amendments and restatements since the last determination letter. In contrast, frequently no formal governing document exists for government plans; the plan's provisions are contained instead in a statute or other ordinance. In addition, in many cases no initial determination letter has ever been requested (or has not been requested for 20 years or more). Finally, tax law changes since the last determination may not have been reflected in the plan or governing statutes and ordinances, but handled through administrative rules or determined not to be relevant. (It is worth noting that the IRS requires the plan document to contain certain items, even if they could never apply.)

Adding to a public plan's difficulties, the ability of a plan governed by statute to take any corrective action deemed necessary by the IRS within the required time frame may be severely restricted (in contrast with private plans that often have the ability to make plan amendments relatively quickly). This is particularly the case where legislation is required and the legislature is not in session.

Recent guidance from the IRS has described its willingness to work with public plans that do not have a single governing document, provided the plan can submit documentation, including copies of timely executed amendments, in an organized manner. However, plans that have not made amendments on a timely basis may be required to make their submissions using the Voluntary Correction Program (VCP).

Multiple retirement plans governed by a single statute (e.g., the 1937 Act plans in California) may encounter an unusual situation. While multiple retirement plans each may want a letter, there is only one plan document to be reviewed. The IRS has had no process historically for dealing with such a situation. Plans that find themselves in this quandary may be able to coordinate efforts and discuss a solution with the IRS that includes a single review of the statute, on which all plans can subsequently rely.

Obtaining a determination letter is a significant commitment in human resources and financial cost. Consequently, we encourage public plans that take this path to leverage their efforts by obtaining updated determination letters in the future.

What to do next?

Since the deadline for filing for a determination letter is January 31, 2009, public plans should consider immediately taking several steps:

1. Determine whether your retirement plan has previously filed for a determination letter. If so, documentation may already exist that can form the basis of a new filing.
2. Discuss with legal counsel whether your system should apply for a determination letter by January 31, 2009.

3. Work with legal counsel and tax advisors to determine options and possible solutions.

Regardless of whether you decide to apply for a determination letter by January 31, 2009, the IRS will continue its effort to ensure that government plans are in compliance with federal tax law. Getting involved in the discussion now may help make the end result more palatable for public plans.

¹ The EPCRS is a collection of correction programs for plan sponsors whose qualified plans have not met applicable Internal Revenue Code (IRC) requirements for a period of time. These include the Voluntary Correction Program.

What does it mean for a plan to be "qualified"?

A "qualified" retirement plan is afforded special tax treatment by the IRS, in return for satisfying specific requirements of the Internal Revenue Code (IRC) detailed in section 401(a) of the IRC. Generally, government plans are subject to fewer requirements than private plans. Here are some of the requirements for government plans to be qualified:

- A clear, complete document must detail how the plan will operate and benefits will be provided. The plan must operate in accordance with the written document.
- Plan assets must be used solely for the benefit of employees and beneficiaries.
- Benefits must not be paid in excess of IRC section 415 limits.
- Compensation eligible for benefits must be limited to the IRC section 401(a)(17) limit, which is generally \$230,000 in 2008, but may be significantly higher for eligible employees who are grandfathered under the plan as of July 1, 1993.
- The plan must distribute benefits in accordance with required minimum distributions and the terms of the governing documents.
- Actuarial assumptions used to determine benefits must be defined in the governing document.

Hot Topic: Market Value of Liabilities

by Karen Steffen

One of the public pension plan sector's most actively discussed topics has picked up momentum within the actuarial profession. The American Academy of Actuaries has set up a Public Interest Committee forum discussion on September 4, 2008, regarding whether it is in the public interest to disclose the market value of assets and liabilities for public pension plans. Many consultants do not believe the disclosure is applicable to public pension plans because of the differences between private and public pension

plans. Those who support the "Market Value of Liabilities" (MVL) are basing their statements on the new discipline of financial economics. It defines the economic value of the benefit obligations as the accrued benefit earned to date, based solely on years of service and salary on the valuation date, and uses a "risk free" rate of return similar to Treasury bills. The pros and cons of this issue are subject to much discussion. Please refer to your Milliman consultant for resources providing statements on both sides of the issue.

This publication is intended to provide information and analysis of a general nature. Application to specific circumstances should rely on separate professional guidance. Inquiries may be directed to: Brent Banister, Editor; 1120 South 101st Street, Suite 400, Omaha, NE 68124-1088; (402) 393-9400; periscope@milliman.com. Offices in principal cities worldwide